Chart of the Month

November 2017

The U.S. Treasury yield curve, which measures the difference between short- and long-term interest rates, has flattened to a 10-year low. The narrowing is primarily due to the fact that short-term yields have advanced more than long-term yields since the Federal Reserve began raising rates nearly two years ago.

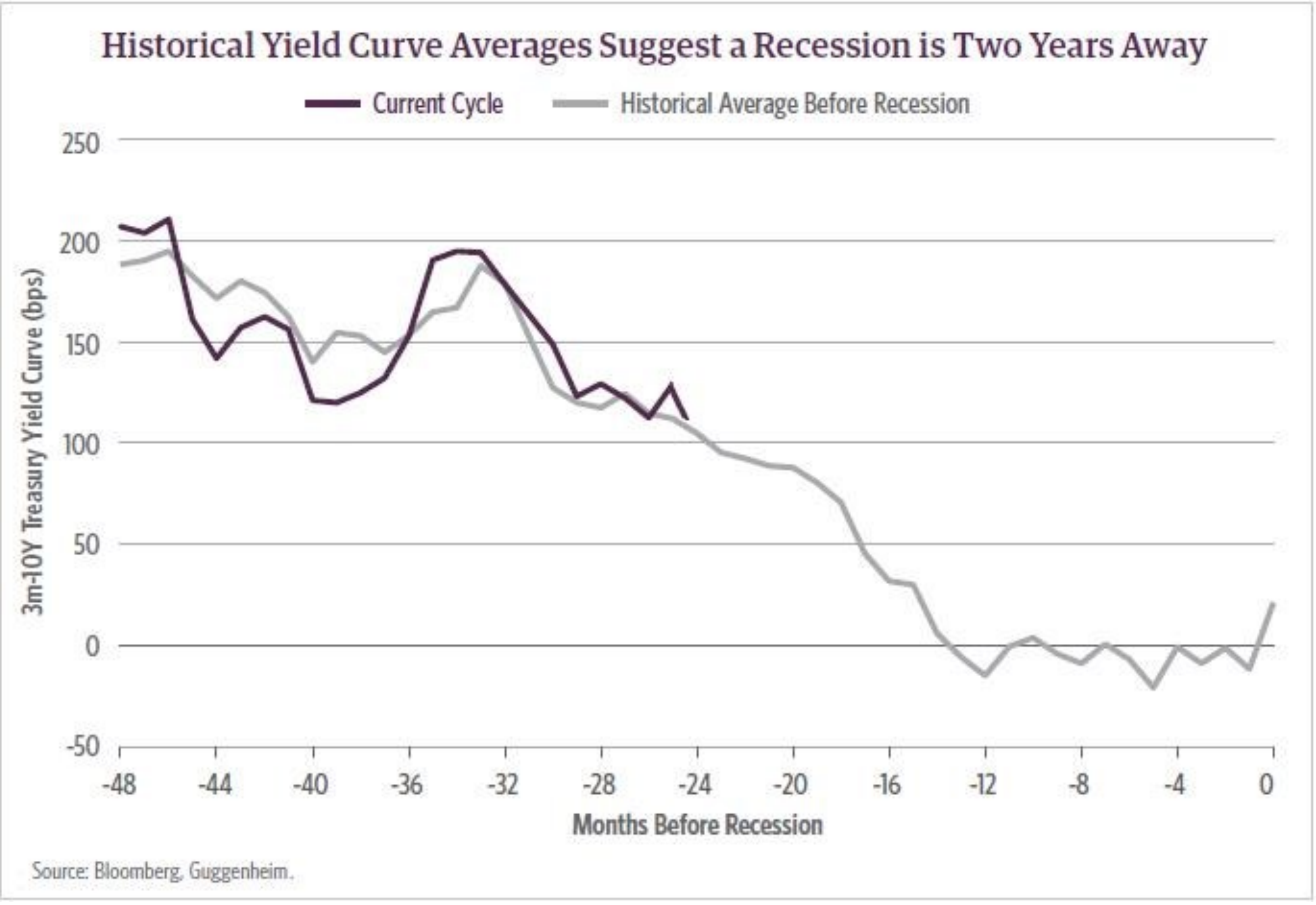
As detailed in the chart below, the difference between the yields on the 3-month Treasury bill (1.26%) and the 10-year Treasury note (2.36%) is currently 1.10% or 110 basis points (bps). The spread was nearly 200 bps less than a year ago and over 200 bps two years ago.

Of note, the spread is expected to continue to dwindle over time as the Fed pushes up short-term interest rates. In fact, the market believes there is a 91.5% probability that the Fed will increase the fed funds rate 0.25% to 1.50% at the next Federal Open Market Committee (FOMC) meeting on December 13. If the market is correct and the yield on the 3-month T-bill increases commensurately and the 10-year Treasury note remains unchanged, the spread between the two will narrow to less than 1.00% (100 bps).

Not for nothing, the market believes there is an 8.5% chance that the fed funds rate will jump 0.50% to 1.75% at the next FOMC meeting. While such a move is unlikely, it would narrow the gap between short- and long-term rates dramatically as this action might serve to *lower* the yield on the 10-year Treasury while raising the rate on T-bills.

The yield curve becomes inverted when short-term yields exceed long-term yields. Importantly, a negative spread usually portends a recession in the not too distant future. With the foregoing in mind, if the 3-month/10-year Treasury yield curve flattens at a rate consistent with past cycles, the likelihood of a recession is only two years away as illustrated in the accompanying chart.

In the meantime, the U.S. economy is actually strengthening with growth topping 3% in the second and third quarters and on pace to reach that mark in the fourth quarter. If so, it would be the first time since the expansion began in mid-2009 in which growth hit that level for three straight quarters. The business cycle would likely extend into 2018 and beyond if Congress passes legislation that lowers the corporate tax rate to 20%. The bottom line is that the economy should continue to perform well over the foreseeable future but a prolonged period of Fed tightening could lead to the next downturn by late 2019 or early 2020.



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